Office of Chief Counsel
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Memorandum

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subject: Application of Section 356(a)(2) to Distribution of Cash in Year 2 Restructurings

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Parent =

DSub 1 =

FSub 1 =

LLC =

FSub 3 =

FSub 4 =

FSub 5 =

FSub 6 =

FSub 7 =

Country 1 =

Country 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Year 1 =

Year 2 =

A =

B =

C =

D =

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AA =

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DD =

EE =

FF =

GG =

I. Statement of the Issue

For the purposes of this analysis, two of Parent's Country 2 subsidiaries are treated as having transferred their assets to Parent's indirect Country 1 subsidiary ("FSub 1") in reorganizations under I.R.C. § 368(a)(1)(D) ("D" reorganizations). FSub 1 simultaneously transferred FSub 1 stock and $A to Parent. For purposes of this analysis, this Office accepts the Service economist's valuations.

Issue: To what extent does the $A cash distribution have the "effect of a distribution of a dividend" under § 356(a)(2)?

II. Background

Since at least Year 1, Parent, a domestic corporation, has been the common parent of an affiliated group of corporations that files a consolidated return, the Parent Group Inc. and Subsidiaries (Taxpayer). Just prior to the time of the transaction at issue in this memorandum, Parent owned all of the stock of DSub 1, a domestic corporation, and, through DSub 1, indirectly owned all of the stock in FSub 1, domiciled and incorporated in Country 1.

From Date 3 to Date 6, Parent engaged in a series of restructuring transactions in which, for US federal income tax purposes, it was deemed to transfer the stock of three Country 2 corporations: FSub 4, FSub 5 and FSub 6 (the "Country 2 Subsidiaries") to FSub 1. Following FSub 1's acquisition of the Country 2 Subsidiaries, each Country 2 Subsidiary became a disregarded entity for US federal income tax purposes. FSub 1

distributed $A and B shares of FSub 1 stock to Parent.[1] Taxpayer did not report taxable income from this distribution and claimed that the distribution was part of a § 368(a)(1)(D) reorganization.[2]

Exam did not respect Taxpayer's characterization of the transaction as a § 368(a)(1)(D) reorganization and asserted that the transaction lacked the required business purpose under Treas. Reg. § 1.368-1(c). In July 2009, Taxpayer filed a Protest and argued that the reorganization met all the requirements of § 368(a)(1)(D) and that Taxpayer was not liable for taxable income from the reorganization in the tax year at issue. Appeals returned the case to Exam, requesting more information on the application of § 356(a)(2). In addition, Appeals asked that a Service economist determine the fair market values (FMVs) of Parent's stock in each of the Country 2 Subsidiaries at the time of the transfer.

Taxpayer's and Exam's documents generally discuss the transaction at issue as if there was (or was not) a single "D" reorganization. This Office disagrees with this oversimplification of the transaction. Parent's transfer of each of its three Country 2 subsidiaries must be separately analyzed. Based on facts agreed upon by the Taxpayer and Exam, this office concludes that only FSub 4 and FSub 6 could have been target corporations in "D" reorganizations. Taxpayer and Exam agree that the third Country 2 subsidiary, FSub 5, had no value at the time of the transaction. Accordingly, this Office finds that FSub 5 did not participate in a "D" reorganization. Thus, the § 356 analysis only is relevant in assessing the consideration Parent is deemed to have received in exchange for its FSub 4 stock and its FSub 6 stock. For the purpose of our § 356 analysis, this Office assumes that there was a *bona fide* business purpose for FSub 1's deemed acquisition of FSub 4's and FSub 6's assets. However, for the purpose of completion, this Office discusses the tax treatment of the entire B shares of FSub 1 stock and the entire $A.

III. Fact Summary

Immediately before the restructuring, Parent directly owned all of the shares of a domestic corporation, DSub 1. DSub 1 directly owned all of the shares of FSub 1, a Country 1 corporation. Parent also directly held membership interests in LLC, a domestic entity that was disregarded for federal income tax purposes. LLC directly held all of the equity in FSub 3, a Country 2 entity that was also disregarded for federal income tax purposes.[3] FSub 3 directly held all of the stock of the following Country 2 entities:[4]

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[1] Taxpayer's response to IDR-IE-010, "Summary of Foreign Reorganization Transaction Steps," Step 11; Taxpayer substantiated that Parent received $A, in response to IDR-IE-052.

[2] In its Year 2 Form 1120, Taxpayer reported that Parent received $C from the reorganization.

[3] When a corporation wholly owns an "eligible entity," and such eligible entity (by default or by an election) qualifies to be classified as a "disregarded entity" (see Treas. Reg. § 301.7701-2 and -3), the disregarded entity is treated as a division of its sole owner for US federal income tax purposes. The items of income, gain, deductions and losses of the disregarded entity are taken into account by its sole owner. For the

(1) FSub 4;
(2) FSub 5; and
(3) FSub 6.

On Date 4, Parent transferred to FSub 1 all its membership interests in LLC plus an £D ($E) receivable (FSub 3 was the debtor). At such time, Parent received a $A cash distribution from FSub 1 and B shares of FSub 1 stock valued at $F.

As LLC and FSub 3 were disregarded entities, Parent was deemed to directly transfer the assets and liabilities held by LLC or FSub 3 (including the stock of FSub 4, FSub 5 and FSub 6) to FSub 1. Upon FSub 1's acquisition of the Country 2 Subsidiaries, each Country 2 Subsidiary elected to be a disregarded entity effective Date 6.[5] Accordingly, each Country 2 target subsidiary was deemed to liquidate at the close of business on Date 5.[6] Characterizing the transaction as a reorganization under § 368(a)(1)(D), the Taxpayer asserts that the cash distributed from FSub 1 to Parent was part of a "D" reorganization governed by § 356(a) and that, because Parent realized no gain on the exchange of the Country 2 Subsidiaries, the distribution of cash to Parent was tax-free under § 356(a)(1).[7]

The following table reflects the valuation of each item Taxpayer was deemed to transfer to FSub1 and Taxpayer's valuation of the B shares of FSub 1 stock. It also provides Parent's basis in its stock in each Country 2 Subsidiary.

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purpose of determining if an entity is eligible to be a disregarded entity, any equity interests held by a disregarded entity are treated as held by the disregarded entity's regarded sole owner. Thus, for the period of time that Parent owned LLC (a disregarded entity) and FSub 3 (a disregarded entity), Parent was treated as owning the assets of LLC and FSub 3, including the stock of FSub 4, FSub 5 and FSub 6, for US federal income tax purposes.

[4] FSub 3 also held all the stock of FSub 7, a Country 2 entity.

[5] Effective Date 6, FSub 1 filed Forms 8832 on behalf of the Country 2 target subsidiaries, electing to change each Country 2 target subsidiary's classification from an association taxable as a corporation to that of an entity that is disregarded as separate from its sole shareholder.

[6] Treas. Reg. § 301.7701-3(g)(iii). Note that FSub 5's deemed liquidation would not qualify under § 332 because it did not have any "property" to distribute in its deemed liquidation.

[7] Taxpayer's Protest, pg. 80.

CHART #1

Subsidiary Or Asset	Taxpayer's Valuation[8]	Service Economist's Valuation[9]	Parent's Tax Basis[10]
FSub 4	$G (unsubstantiated, disputed)	$L	$N
FSub 5	0	0	0
FSub 6	$H (unsubstantiated disputed)	$M	$O
FSub 3	$I	$I[11]	$P
FSub 3	$E[12]		
Taxpayer's Rounded Subtotal	$J		
Cash Paid To Parent	$A		
+B Shares Of FSub 1 @ $FF per share	$F		
Total Distribution Value to Parent	$K		

[8] Taxpayer's response to IDR-EC-002.

[9] See Service's Economist Report on Valuation in Year 2, January 29, 2010.

[10] These amounts are subject to verification.

[12] It is unclear whether this value is also included in the FSub 3 value, above.

The earnings & profits (E&P) of each relevant entity is listed below:[13]

CHART #2

Subsidiary	Current E&P	Accumulated E&P (Including Current E&P)
FSub 4	$Q Date 2 to Date 4	$T as of Date 4
FSub 5	0	0
FSub 6	$R Date 2 to Date 4	$U as of Date 4
FSub 1		$V as of Date 1
FSub 1	$S Date 7	$W as of Date 7

Parent's E&P in the above chart does not reflect the $A that FSub 1 distributed to Parent, because FSub 1 treated this amount as payment to acquire the stock of FSub 4, FSub 5, and FSub 6, which Taxpayer claims did not affect E&P. Taxpayer states that FSub 1's accumulated E&P for tax year ended Date 7 includes the E&P of FSub 6, FSub 5, and FSub 4's earnings between Date 5 and Date 7. Taxpayer did not provide FSub 1's E&P as of Date 4.

Taxpayer's Position

Taxpayer asserts that Parent's receipt of cash is tax-free because Parent received it in connection with a § 368(a)(1)(D) reorganization. Taxpayer claims that Parent realized no gain on the exchange of any of stock of the Country 2 Subsidiaries, and, therefore, Parent's receipt of cash was subject to § 356(a)(1).

IV. Law and Analysis

A. Overview of Parent's Taxation under § 356(a)(2)

In light of the information that Exam has provided, this Office advises that $CC of the cash distribution is taxable to Parent under § 356(a)(2) and § 301(c)(1). Before setting forth the § 356 analysis in detail, this Office discusses certain related issues.

[13] Taxpayer's response to IDR-IE-051.

B. Value-for-Value Exchange

FSub 1 directly issued (in the aggregate) B shares of its stock (valued at $F) and $A in cash directly to Parent in exchange for Parent's interests in LLC. As LLC was disregarded for federal income tax purposes, and under the application of the step transaction doctrine, FSub 1 is treated as having received all of the assets of FSub 4 in a "D" Reorganization, all of the assets of FSub 6 in a "D" Reorganization, "Additional Assets" and the $E Receivable from Parent. As listed in the above chart, Exam's and Taxpayer's valuations differ in some respects. Exam found that the aggregate value of the assets FSub 1 acquired was approximately $X. This is approximately $Y more than FSub 1 paid for the assets. In order to create a value-for-value exchange, this Office concludes that FSub 1 must be deemed to have issued additional FSub 1 stock ("Deemed Shares") to Parent in the transaction.[14]

C. Tax Treatment of the $E Receivable

Parent transferred a $E receivable (the "Receivable"). FSub 3 was the debtor with respect to the Receivable. As FSub 3 was a disregarded entity, prior to the transfers at issue, Parent was deemed to be both the debtor and creditor with respect to the $E. After the transfers, FSub 1 was deemed to hold both the $E debt and $E Receivable. The debt and Receivable offset each other and are disregarded for US federal income tax purposes. Taxpayer's analysis of this part of the transaction is unclear. It appears that Taxpayer may have allocated some of the $A to FSub 1's acquisition of the Receivable. If Taxpayer did so, the allocation is incorrect. Taxpayer and Exam agree that the transfer of the $E Receivable and the related debt are unrelated to the "D" reorganizations.

D. Tax Treatment of Parent's Transfer of the "Additional Assets"

FSub 3 held $I of assets (the "Additional Assets") prior to the transfers at issue. As FSub 3 was a disregarded entity, Parent was deemed to transfer these Additional Assets to FSub1. Taxpayer and Exam agree that Parent's transfer of such Additional Assets was separate from the two "D" Reorganizations.

Although Taxpayer's analysis is unclear, it appears that Taxpayer allocated solely cash to FSub 1's acquisition of the Additional Assets. Parent claimed to have a basis of $P in the Additional Assets. Thus, it appears that Parent may have claimed a $GG loss on its deemed transfer of the Additional Assets to FSub1 under § 1001. To the extent that Parent claimed a loss on the transfer of the Additional Assets, such loss should be denied. As noted above, for non-US federal income tax purposes, FSub 1 issued stock and cash to Parent in exchange for Parent's interests in LLC. For US federal income

[14] To put the parties back into their actual economic stance, Parent would be deemed to transfer these Deemed Shares to DSub 1. Parent's basis in its FSub 6 shares (as adjusted under § 358(a)(1)(A) and (B)) would be allocated among its FSub 1 shares (actual and Deemed).

tax purposes, the FSub 1 stock (the B FSub 1 shares and Deemed Shares) must be allocated to the assets of FSub 4, the assets of FSub 6 and the Additional Assets. For the allocations, see Chart #3, below. For US federal income tax purposes, Parent must be treated as transferring the Additional Assets to FSub 1 in a § 351 transaction.[15] Section 351(a) and (b) preclude Parent from recognizing a loss on its transfer of the Additional Assets to FSub 1.

E. The Section 368(a)(1)(D) Reorganizations

Section 368 (a)(1)(D) defines a "D" reorganization as follows:

> [A] transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

(1). Only FSub 6 and FSub 4 engaged in "D" Reorganizations

Taxpayer's application of § 368(a)(1)(D) to the instant case is unclear. In some discussions, it appears to treat Parent's deemed transfer of FSub 4, FSub 5 and FSub 6 to FSub 1, and the check-the-box elections of the three Country 2 subsidiaries as a single "D" reorganization. In other discussions, Taxpayer appears to conclude that there were three "D" reorganizations: (1) FSub 1's acquisition of FSub 5; (2) FSub 1's acquisition of FSub 6 and (3) FSub 1's acquisition of FSub 4. Taxpayer concludes that FSub 1's acquisition of the stock of each Country 2 Subsidiary followed by the deemed liquidation of such subsidiary into FSub 1 qualifies as a "D" reorganization.

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[15] Section 351 provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons in exchange for stock of such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

Because LLC and FSub 3 were disregarded entities, Parent was deemed to directly transfer the Additional Assets to FSub 1 in exchange for FSub 1 stock. Parent's deemed transfer of the Additional Assets to FSub 1 in exchange for FSub 1 stock qualifies under § 351(a). Section 351 requires the transferor to control the transferee corporation immediately after the exchange. For this purpose, control is defined by § 368(c) (at least 80% of the combined total voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of such corporation). After the transaction, Parent would directly hold B shares of FSub 1's stock and Deemed FSub 1 shares (including the part of the B shares and Deemed Shares Parent acquired in the two "D" reorganizations) and be treated as owning all of the FSub 1 stock owned by DSub 1 under the application of § 1.1502-34. Thus, Parent would be treated as owning 100 percent of FSub 1 and would satisfy the § 351 "control" requirement.

This Office concludes that FSub 1's acquisition of FSub 4, followed by FSub 4's check-the-box election, qualifies as a "D" reorganization. We also conclude that FSub 1's acquisition of FSub 6, followed by FSub 6's check-the-box election, qualifies as a "D" reorganization. See Rev. Rul. 67-274, 1967-2 C.B. 141 (holding that if pursuant to a plan, corporation Y acquired the stock of corporation X in exchange for Y stock and X liquidated into Y, the transaction is treated as if Y acquired the assets of X in exchange for Y stock in a § 368 reorganization). Thus, FSub 4 would be treated as transferring all of its assets to FSub 1 in one "D" reorganization, and FSub 6 would be treated as transferring all of its assets to FSub 1 in another "D" reorganization.

FSub 1's acquisition of FSub 5 does not qualify as a "D" reorganization. FSub 1 can not be treated as issuing stock (or other consideration) to FSub 5 if FSub 5 had a value of $0.[16] To the extent that FSub 5 had no assets, no value and no U.S. tax attributes, and to the extent that Parent had no basis in its FSub 5 stock, FSub 5 is not relevant to our discussion. However, if Taxpayer's information is inaccurate and/or if FSub 5 had liabilities or tax attributes at the time of the transfer, this Office would revisit this analysis.

(2). *<u>Cash and Stock Consideration Must be Allocated</u>*

FSub 1's acquisition documents describe its acquisition of LLC. For non-tax purposes, FSub 1's payment to Parent of cash and FSub 1 stock was in payment for Parent's membership interests in LLC. The consideration that FSub 1 paid for Parent's membership interests in LLC must be bifurcated among the assets FSub 1 is deemed to have acquired in the transaction for US federal income tax purposes.

Although Taxpayer recognizes that it must treat some of FSub 1's consideration as in payment for the assets of FSub 4, the assets of FSub 6, and the Additional Assets, Taxpayer's actual allocations are far from clear. It appears as though Taxpayer takes the position that it can allocate all of the stock consideration to the "D" reorganizations and allocate only cash to FSub 1's acquisition of the Receivable and the Additional Assets. We have addressed the proper treatment of the $E Receivable and the Additional Assets above. This Office takes the position that the FSub 1 stock (the B shares and Deemed Shares) and cash must be allocated proportionally among all of the assets that FSub 1 was deemed to have acquired as set forth in Chart #3, below.

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[16] The step transaction analysis giving rise to the "D" reorganization relies on the acquiring corporation's acquisition of the target corporation's stock and the target corporation's qualifying § 332 liquidation. FSub 5's deemed liquidation would not qualify under § 332 as FSub 1 would not be treated as receiving "property" from FSub 5 in exchange for "stock."

CHART # 3

Company	**TP's Valuation** [17]	**IRS's Valuation**	**Parent's Tax Basis**[18]	**Gain § 1001**	**$ Cash/ "Boot" Allocation R. Rul. 68-55**
FSub 4	$G(unsubstantiated & disputed)	$L	$N	0	$BB
FSub 5	0	0	0	N/A	N/A
FSub 6	$H (unsubstantiated & disputed)	$M	$O	$AA	$CC
FSub 3	$I	$I[19]	$P	0	$DD
Total	$Z				

While this Office agrees that FSub 1 is to be treated as acquiring the assets of FSub 4 and the assets of FSub 6 in "D" Reorganizations, we find a number of flaws in Taxpayer's position.

As discussed above, FSub 1 must be deemed to have issued additional FSub 1 shares ("Deemed Shares") in order to construct a value-for-value exchange and a portion of the (aggregate) FSub 1 shares must be allocated to the Additional Assets

(3). The FSub 6 "D" Reorganization

Given Exam's valuations, Parent's basis in its FSub 4 stock exceeded the value of such stock. Thus, our discussion of § 356(a)(2) will focus on the FSub 6 "D" reorganization. Under the application of § 356(a)(2), the Supreme Court's analysis in Commissioner v. Clark, 489 U.S. 726 (1989) (hereinafter Clark), and other authority, this Office concludes that Parent's receipt of $CC of the cash allocated to the FSub 6 "D" reorganization is ultimately governed by § 301(c)(1).

(i) Operative Provisions of § 368(a)(1)(D): §§ 354 and 356

Although § 368(a)(1)(D) provides the definition of a "D" reorganization, it does not provide the operative rules that govern the treatment of the parties to the reorganizations or the treatment of Parent. Sections 354 and 356 discuss the target shareholder's tax treatment.

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[17] Taxpayer's response to IDR-EC-002.

[18] See Service's Economist Report on Valuation in Year 2, January 29, 2010.

[19] In response to IDR-EC-002, Taxpayer provided values on selected net assets of FSub 3. Due to a lack of other financial information, the Service Economist does not dispute these amounts.

Section 354

Section 354(a)(1) governs the target shareholder's treatment in a "D" reorganization if the shareholder receives solely qualifying property (*i.e*., stock of the issuing corporation). Section 354(a)(1) states that "[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." § 354(a)(1).

Section 354(b) states that § 354(a) will not apply to a § 368(a)(1)(D) exchange unless:

> (A) The corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and
>
> (B) The stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Section 354 bars the shareholder from recognizing a loss on such an exchange.[20]

Section 356

Section 356 governs the target shareholder's treatment in a "D" reorganization if the shareholder receives, in addition to stock of the issuing corporation, cash or other non-qualifying property ("boot") in exchange for its stock in the target corporation in pursuance of the plan of reorganization.

Under 356(a)(1), which states the general rule, any gain that the shareholder realizes from the exchange of its target stock is treated as capital gain up to the value of the boot. The shareholder recognizes gain, if any, in the amount not to exceed "the sum of such money and the fair market value of such other property." § 356(a)(1); Treas. Reg. § 1.356-1(a)(1). The shareholder may not recognize a loss, if any, from the exchange or distribution. Treas. Reg. § 1.356-1(a)(2).

Congress recognized that shareholders could use reorganizations to bail out corporate earnings at capital gains rates rather than at the higher rates applicable to dividends. In an effort to prevent such a result, Congress enacted § 356(a)(2).[21] Section 356(a)(2) is an exception to the general "boot" recognition rule in section 356(a)(1). Section

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[20] Accordingly, even if Parent's basis in its FSub 4 stock exceeded the stock's value, Parent is not allowed to recognize a loss upon exchanging such stock for FSub 1 stock and cash. See § 356(c).

[21] Congress enacted the predecessor of § 356(a)(2), § 203(d)(2), in the Int. Rev. Act of 1924, 43 Stat. 253. Congress expressed concern that if "boot income" were to be taxed only at capital gains rates, profits (otherwise ordinarily distributed as dividends) would escape the full tax rates. Congress enacted § 203(d)(2) to prevent this distortion, taxing the boot as dividend income where applicable.

356(a)(2) states that if the "exchange…has the effect of the distribution of a dividend," any gain realized (to the extent of boot) must be treated as a dividend and is taxed as ordinary income. (Emphasis added.)

Under Taxpayer's analysis, Parent's receipt of boot in connection with the FSub 6 "D" reorganization could not have "the effect of the distribution of a dividend" because FSub 6 did not have any accumulated E&P at the time of the "D" reorganization. As discussed below, Taxpayer's analysis is incorrect. We address this issue more fully in our discussion of Clark (regarding how to determine when an exchange has the effect of the distribution of a dividend under § 356(a)(2)).

Cash Distribution Taxable under § 356(a)(2)

Contrary to Taxpayer's position, this Office concludes, based on Exam's findings, that § 356(a)(2) governs Parent's receipt of boot in the FSub 6 "D" reorganization and that, applying the Supreme Court's analysis in Clark, the $CC distribution had the effect of a § 301(c)(1) dividend under § 356(a)(2).

In determining the amount of the dividend, Parent first determines whether it has realized gain on its exchange of its FSub 4 shares and its FSub 6 shares under § 1001. Parent realized, but cannot recognize, a loss on the exchange of the FSub 4 shares. Parent realized a gain on the (deemed) exchange of its FSub 6 stock. The IRS's valuation expert found that the FMV of the FSub 6 stock held by Parent was $M. Parent's basis in such stock was $O. Thus, Parent realized a gain of $AA (*i.e.*, $M – $O) upon exchanging its FSub 6 stock for FSub 1 stock and boot. Section 356 and Clark determine to what extent and how the realized gain is to be recognized.

As set forth in Chart #3, Parent is treated as having received $CC of the total cash[22] in addition to FSub 1 Shares (including an allocable portion of the B FSub 1 Shares plus Deemed Shares)[23] in connection with the FSub 6 "D" reorganization. The allocations in Chart #3 apply the principles of Rev. Rul. 68-55, 1968-1 C.B. 140.

Section 356 states:

(a) GAIN ON EXCHANGES. –

(1) RECOGNITION OF GAIN. – If –

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[22] FSub 1 provided the $A directly to Parent. The Taxpayer needed to determine how much of the total cash Parent was deemed to have received with respect to the two target Country 2 Subsidiaries and the Additional Assets. Under Rev. Rul. 68-55, the Taxpayer allocates this cash, in proportion to the fair market value of each asset class, to each class of asset received and specifically to (1) the assets FSub 1 is deemed to receive from FSub 4 in a "D" Reorganization; (2) the assets FSub 1 is deemed to receive from FSub 6 in a "D" Reorganization; and (3) the Additional Assets that FSub 1 is deemed to receive from Parent.

[23] Using the IRS expert's valuation, Parent would be treated as having received $EE in FSub 1 shares.

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) TREATMENT AS DIVIDEND. - If an exchange is described in paragraph (1), but has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

Although Parent realized more than $CC of gain, Parent can only have recognition treatment up to the amount of the "boot" it received in the reorganization. See § 356(a)(1). Thus, Parent's maximum recognition in the FSub 6 "D" reorganization is $CC.

Section 356(a)(2) requires that to the extent that the $CC of cash "has the effect of the distribution of a dividend (determined under the application of section 318(a))", it shall be recognized as such up to the amount of the gain. Section 356 is silent on how to determine if a distribution "has the effect of a dividend."

(ii) The Clark Analysis – $CC of the Boot Has the Effect of a Dividend

To determine whether a distribution has the "effect of the distribution of a dividend" under § 356(a)(2), the Supreme Court in Clark articulated a post-reorganization fictional redemption test.

The Clark test imposes a two-pronged fiction. First, the test sets aside the actual transaction and treats the target shareholder (*i.e.*, Parent) as receiving solely stock of the issuing corporation (*i.e.*, FSub 1 shares) in exchange for its shares of the target corporation (*i.e.*, FSub 6). Second, under the Clark test, FSub 1 would be treated as redeeming some of Parent's FSub 1 shares for "boot" (or cash). This fictional redemption is tested under § 302. The amount of "boot" the shareholder is deemed to receive in the fictional redemption is equal to the amount of boot the shareholder actually received in the § 356 exchange. The IRS adopted the Clark analysis in Rev. Rul. 93-61, 1993-2 C.B. 118.

In Clark, a target corporation ("Target") merged into an *unrelated* corporation ("Acquiring") in a forward triangular merger. In exchange for his Target stock, Target's sole shareholder received $3,250,000 cash and 300,000 shares of stock of Acquiring's parent ("Issuing"). In lieu of cash and stock, the shareholder could have received solely 425,000 shares of Issuing's stock.

In determining whether payment of the $3,250,000, or "boot", had the effect of a "dividend" for purposes of § 356(a)(2), the Court treated the shareholder as receiving 425,000 shares of the Issuing corporation (representing 1.3% of Issuing's outstanding stock) in connection with the reorganization, and then treated the Issuing corporation as redeeming 125,000 of its shares in exchange for $3,250,000. After the fictional redemption, the shareholder held 0.92% of Issuing's stock and less than 50% of Issuer's voting stock. Thus, the shareholder was treated as having relinquished about 29% of his Issuing stock in the fictional redemption. The Court concluded that the shareholder's exchange of 29% of his Issuing stock for cash in the post reorganization fictional redemption satisfied the "substantially disproportionate" standard of § 302(b)(2).[24] Thus, the shareholder in Clark was entitled to capital gain treatment under § 356 on his receipt of boot in pursuance of the reorganization.

The final step in Clark is to apply § 302 to classify the quantum of change in target shareholder's ownership of Issuing before and after the deemed redemption. Section 302(a) states that if a corporation redeems its stock, and if paragraph (1), (2), (3), or (4) of subsection (b) applies, the exchange shall be treated as a distribution in payment in exchange for the stock (emphasis added). Section 302(b)(1), (2), (3) and (4) provide several "safe harbors" for exchange treatment. Parent does not qualify for exchange treatment under any of these safe harbors.

Section 302(c) requires that in determining the ownership of stock for the purposes of § 302, the constructive ownership rules of § 318 shall apply.[25] As noted above, under

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[24] Section 302(b)(2)(A) provides that § 302(a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

Section 302(b)(2)(B) provides that this paragraph shall not apply unless immediately after the redemption, the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

Section 302(b)(2)(C) provides that for the purposes of this paragraph, the distribution is substantially disproportionate if ---

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of …

(ii) The ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all the voting stock of the corporation at such time.

[25] Until the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), it was unclear whether the constructive ownership rules of § 318, which expressly apply to § 302, were applicable in determining whether a distribution had the effect of a distribution of a dividend under § 356. Section

Clark, Parent is first deemed to receive only FSub 1 stock in exchange for its FSub 6 stock in the "D" reorganization. After this step, under § 318(a)(2)(C), Parent is considered as owning 100 percent of FSub 1 (the issuing corporation): Parent is treated as directly owning the FSub 1 shares it was deemed to receive in the two "D" reorganizations in exchange for its FSub 6 shares[26] and constructively owning all of the FSub 1 shares held by DSub 1.

Next, FSub 1 is deemed to redeem some of its shares from Parent (equal to the value of the "boot" Parent received in the FSub 6 "D" Reorganization). After the deemed redemption, under the application of § 318(a)(2)(C), Parent continues to own 100 percent of FSub 1: Parent directly owns some FSub 1 shares and constructively owns all the FSub 1 shares held by DSub 1. Thus, before and after the fictional § 302 redemption, Parent is treated as owning 100 percent of FSub 1. Therefore, the § 356 distribution has the "effect of a dividend" (to the extent the distribution is supported by E&P).

As noted, the Clark § 356 analysis requires application of § 302, which includes § 302(d). Section 302(d) states that if a corporation redeems its stock, and § 302(a) does not apply (because none of the tests in § 302(b) applies, as in this case), the redemption shall be treated as a distribution of property to which § 301 applies, (*i.e.*, the distribution will be a dividend (assuming sufficient E&P)). (Emphasis added.)

In the case of a reorganization in which the issuing corporation directly acquires the assets of the target corporation, the issuing corporation would succeed to the tax attributes of the target corporation, including the target corporation's E&P. The Clark Court stated that the § 302 redemption must be tested as a post-reorganization redemption by the issuing corporation. Thus, in a non-triangular reorganization, the § 316 determination would include the E&P of both the target and the issuing corporation.[27]

227(b) of TEFRA resolved this issue. It amended § 356(a)(2) to provide that § 318 is to be applied with respect to distributions made after Aug. 31, 1982.

Section 318(a)(2)(C) states that if 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation. Prior to the "D" Reorganizations, Parent owned 100 percent of DSub 1 and DSub 1 owned 100 percent of FSub1. Therefore, under § 318(a)(2)(C), prior to the "D" reorganizations Parent was considered to own 100 percent of FSub 1.

[26] The valuations will not change the outcome of the Clark analysis when applied to the Taxpayer's transaction. Via application of § 318, Parent will be treated as owning 100% of FSub 1 before and after its deemed redemption of FSub 1 stock.

Include FSub 6's and FSub 1's E&P in Determining the Amount of the Dividend

Taxpayer's representative's opinion asserts that only FSub 6's, and not FSub 1's, E&P is taken into account in determining whether the cash distribution is a dividend.[28] The Tax Court took this same position in Davant v. Commissioner, 43 T.C. 540 (1965). The Court of Appeals for the Fifth Circuit overruled the Tax Court on this point.

The Fifth Circuit concluded that "[w]here there is complete identity of stockholders, the use of the earnings and profits of both corporations is the only logical way to test which distributions have the effect of a dividend.[29] Davant v. Commissioner, 366 F.2d 874, 889 (5th Cir. 1966), *aff'g in part and rev'g in part* 43 T.C. 540 (1965). The Fifth Circuit concluded that if the target corporation had not distributed its earnings to its shareholders prior to the reorganization, the target's E&P would have combined with the issuing corporation's E&P under § 381. Thus, the Fifth Circuit concluded that the cash received by the shareholders "must be tested against [the target and issuing corporation's] combined earnings and profits." Davant at 887.

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[27] The Clark case involved a triangular reorganization. In such case, the issuing corporation would not succeed to the target corporation's E&P under § 381. Unlike § 304, Clark does not affirmatively require that one take into account both the issuing and target corporation's E&P in determining whether the distribution has the effect of a dividend. However, the logic of Clark mandates that one must take into account the E&P of the issuing corporation.

[28] The Ginsburg & Levin treatise states without explanation:

> [a] shareholder who receives both stock … and boot is tax-free on the stock, and the boot is taxed either as a dividend (to the extent of his ratable share of T's accumulated earnings and profits) or as [capital gain], but in neither event in excess of the gain which would have been realized if the transaction were fully taxable. Note that what counts is T's (and not P's) accumulated (not current) E&P, and only the shareholder's ratable share of that.

Martin D. Ginsburg & Jack S. Levin, Mergers, Acquisitions, and Buyouts ¶ 801.4.3. (July 2009).

Consistent with its subsequent opinion in *Davant*, the Tax Court determined that only the target corporation's E&P is used in calculating the amount of the dividend in James Armour, Inc. v. Commissioner, 43 T.C. 295 (1964).

[29] The Fifth Circuit noted that the statute, in speaking of 'the corporation,' means the corporation controlled by the stockholders receiving the distribution. It explained that where there is complete identity, as here, the stockholders control both corporations, and it is virtually impossible to tell which corporation is in reality 'the corporation' distributing the cash.

Most importantly, it is the long-standing position of the IRS that the issuing corporation's E&P is taken into account in determining whether a distribution is a dividend. Rev. Rul. 70-240, 1970-1 C.B. 81, tracks the facts in Davant. In Rev. Rul. 70-240, two corporations were wholly owned by a single shareholder. Corporation "X" sold its operating assets to its sister corporation, "Y," for $34x cash. X's remaining assets were valued at $33x. Following the sale, X used $38x to pay its debts and then liquidated, distributing $29x in cash. The ruling holds that the combined steps qualify as a "D" reorganization. Citing Davant, the ruling states that "[w]here, as here, there is complete shareholder identity, both corporations will be considered 'distributing' corporations, for purposes of determining whether a distribution has the effect of a dividend."[30] (Emphasis added.)

As shown in Chart #2, FSub 1 had enough E&P to treat the entire $CC as a dividend.

It is this Office's position that the target and acquiring corporations' E&P must be taken into account in determining whether the "boot" has the effect of a dividend. However, we point out that even in the absence of E&P, the Taxpayer would not escape recognition upon its receipt of $CC of boot in connection with the "D" reorganization. Section 356(a)(1) requires immediate gain recognition if the target shareholder's basis in the target stock is less than the stock's FMV and the shareholder receives "boot" in the transaction. Section 356(a)(1) requires that "gain, if any, to the recipient shall be recognized (to the extent of the boot)."

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Please call Joanne M. Fay at (202) 622-7770 if you have any further questions.

[30] Note that the holding of Rev. Rul. 70-240 is consistent with § 304(b)(2), which takes into account the E&P of both the acquiring corporation and the issuing corporation.